CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
STATEMENT OF INVESTMENT POLICY

FOR
ASSET ALLOCATION STRATEGY

February 18, 2003

This Policy is effective immediately upon adoption and supersedes all previous asset allocation strategy policies.

I. PURPOSE

This document sets forth the investment policy, guidelines, and procedures ("the Policy") for determining the strategic management of the California Public Employees' Retirement System's ("the System") assets through their allocation, known as the Asset Allocation Strategy ("the Program"). The Policy allows for sufficient flexibility to capture investment opportunities as they may occur, yet provides reasonable parameters to ensure prudence and care while managing the Program. The System recognizes that asset allocation decisions generally account for about 90% of the investment return for a large pool of assets.

II. STRATEGIC OBJECTIVE

The Program shall be managed to accomplish the following:

A. Assure the availability of sufficient assets to pay benefits;

B. Minimize and stabilize employer and employee contributions;

C. Achieve the highest rate of total return possible within prudent levels of risk and liquidity; and

D. Maintain sufficient diversification to avoid large losses and preserve capital.

III. RESPONSIBILITIES AND DELEGATIONS

A. The **System's Investment Committee** ("the Investment Committee") approves and amends the Policy. The Committee delegated the responsibility for administering the Policy to the System's Investment Staff.

B. The **System's Investment Staff** ("the Staff") shall conduct analyses and the annual reviews of the Program and present their findings to the Investment Committee. The Staff shall also implement, monitor adherence to and report monthly to the Investment Committee regarding the Program.

C. The **General Pension Consultant** and other consultants deemed appropriate shall assist in the development of the financial study and monitoring the Program. The General Pension Consultant shall review the Program and present its findings to the Investment Committee annually.

IV. BENCHMARK

The Program, at a minimum, shall generate a long-term total return that meets or exceeds the actuarial interest rate assumption.

V. GENERAL

A. The Program shall be determined solely in the interests of the System's beneficiaries. The Program shall ensure that funds are managed with care, skill, prudence, and diligence.

B. The Program shall reflect analyses that consider the current and expected financial condition of the System. Analyses shall also encompass the expected long-term capital markets outlook, the expectations of inflation, the System's liabilities, the integration of assets and liabilities, and the System's overall risk tolerance.

1. Analyses shall consider and include various suitable asset classes and their correlations in accordance with Section V of this Policy.

2. Analyses shall consider relevant and timely decision factors. The System is recognized as a growing and dynamic entity. Therefore, the factors ultimately driving the selection of an asset allocation strategy and their relative importance will change over time. These decision factors shall be reviewed as part of the annual review of the Program, as specified in Section V.C. Decision factors may include, but are not limited to, the following:

    a. Paying benefits with sufficient funds (funded ratio);

b. Minimizing employer contributions as a percent of payroll (contribution rate);

c. Stabilizing employer contributions;

d. Ranking in the top quartile investment performance and;

e. Minimizing event risk.

Analyses of alternative allocation strategies shall measure the potential impact of expected risk and return, diversification, projected liabilities, funded ratio, and contribution rates and variability.

3. The Investment Committee shall approve strategic asset allocation targets and ranges expressed as a percent of the total assets. The Investment Committee shall set ranges, thereby avoiding excessive transaction costs caused by too frequent re-balancing. Nevertheless, ranges shall be sufficiently narrow to maintain the basic risk/return relationship established by the allocation targets.

C. A comprehensive Asset Allocation analysis shall be completed every two years. Additionally, the Program shall be reviewed at least annually to ensure that it achieves expected financial goals it was designed to accomplish and that all assumptions used in establishing the Program are reasonable.

D. In the event that economic circumstances warrant an increase or decrease to a specific asset class, staff has the flexibility to recommend a change to the targets. This flexibility allows staff to add further value to the Fund when it is clear a specific asset class is expected to significantly out perform or under perform other PERS' asset classes on a risk-adjusted basis. Staff shall bring any recommendation to the Investment Committee as part of its annual Investment Plan. Any recommended change to a target would not exceed 2%. A target for cash is exempt from consideration.

VI. ASSET CLASSES

Asset classes that are candidates for inclusion shall be reviewed in conjunction with the Program. Financial and real asset types shall be considered as viable asset classes if they have a risk, return, and correlation profile sufficiently different from other considered asset classes, and if their inclusion or exclusion affects the risk and return expectations of the System's total return.

A. Criteria for an asset class shall include, but are not limited to, the following:

   1. Sufficient size, liquidity, and cost efficiency to permit the System to invest meaningful amounts in that asset class, and to have an impact on total return.

   2. Availability of sufficient internal or external investment and technical expertise to ensure prudent implementation of an investment in that asset class.

   3. Presence of diversification, return enhancement, liquidity provision, or some other readily identifiable attribute sufficiently different from other asset classes and which enhances the System's ability to achieve the strategic objectives outlined in Section II.

   4. Acceptance by other large pension plan sponsors as a viable and meaningful asset class, or in the absence of such acceptance, an academic basis or foundation for its inclusion.

   5. Availability of sufficient data, history, or expertise to assess the viability or benefit of the asset class to the System, by means of a measurable investment outcome. Furthermore, the asset class must have a basis for developing expected investment returns, risks, and correlations for the purposes of the financial study.

B. An asset class may be approved for investment provided it meets the above-mentioned criteria. The Investment Committee has had the opportunity for sufficient education through System-sponsored workshops or other sources or both to enable it to fulfill its fiduciary responsibility in making such an approval.

C. Once the System approves an asset class for investment, as part of the Program, the investment may only be made in accordance with a policy reviewed and approved by the Investment Committee for that asset class. Such a policy shall specify the method and parameters for implementation and provide for the on going monitoring of that asset class.

VII. IMPLEMENTATION, MONITORING, AND REPORTING

A. Implementation of the Program shall take place only after Investment Committee adoption of a transition plan. The plan shall recognize the unique characteristics of the asset classes affected by the transition, the associated costs, the System's policies for each asset class, the System's asset size, and the appropriate time horizon.

B. Adherence to the Asset Allocation target allocations shall be monitored and reported to the Investment Committee as part of the Monthly Chief Investment Officer Report. This report shall display the actual asset allocation on a market value basis versus the target allocation and the permissible range for each broad asset class. The report shall also display the investment performance results of each asset class versus both the appropriate benchmark returns as specified in the asset class Policy and the expected long-term return.

C. The Asset Allocation shall be considered out of compliance when exposure to each broad asset class is above or below its range. To re-establish compliance, the Chief Investment Officer shall develop a plan for Investment Committee consideration for re-balancing the allocations to target, recognizing that the System is a long-term investor and that cost minimization shall be a key consideration. The plan shall reflect the unique characteristics of each asset class, its liquidity, and any other relevant considerations to ensure prudence and care.

D. If market conditions or other relevant and important considerations make rebalancing to target problematic, the Chief Investment Officer may seek an exception to Section. VII.C. of this Policy from the Investment Committee.

VIII. GLOSSARY OF TERMS

Contribution Rate – The ratio of employer contributions divided by payroll.

Decision Factors – A decision factor is a measure or characteristic, used for relating strategic goals to a specific asset allocation decision.

Event Risk – A decision factor measured by the one-year performance relative to a peer group.

Funded Ratio – The ratio of market value to assets divided by liabilities.